12 Things You Need To Know About Financial Statements

By Richard Loth

A A A

Knowing how to work with the numbers in a company's financial statements is an essential skill for stock investors. The meaningful interpretation and analysis of balance sheets, income statements and cash flow statements to discern a company's investment qualities is the basis for smart investment choices. However, the diversity of financial reporting requires that we first become familiar with certain general financial statement characteristics before focusing on individual corporate financials. In this article, we'll show you what the financial statements have to offer and how to use them to your advantage.

TUTORIAL: Advanced Financial Statement Analysis

1. Financial Statements Are Scorecards

There are millions of individual investors worldwide, and while a large percentage of these investors have chosen mutual funds as the vehicle of choice for their investing activities, a very large percentage of individual investors are also investing directly in stocks. Prudent investing practices dictate that we seek out quality companies with strong balance sheets, solid earnings and positive cash flows.

Whether you're a do-it-yourself or rely on guidance from an investment professional, learning certain fundamental financial statement analysis skills can be very useful - it's certainly not just for the experts. Over 30 years ago, businessman Robert Follet wrote a book entitled "How To Keep Score In Business" (1987). His principal point was that in business you keep score with dollars, and the scorecard is a financial statement. He recognized that "a lot of people don't understand keeping score in business. They get mixed up about profits, assets, cash flow and return on investment."

The same thing could be said today about a large portion of the investing public, especially when it comes to identifying investment values in financial statements. But don't let this intimidate you; it can be done. As Michael C. Thomsett says in "Mastering Fundamental Analysis" (1998):

"That there *is* no secret is the biggest secret of Wall Street - and of any specialized industry. Very little in the financial world is so complex that you cannot grasp it. The fundamentals - as their name implies - are basic and relatively uncomplicated. The only factor complicating financial information is jargon, overly complex statistical analysis and complex formulas that don't convey information any better than straight talk." (For more information, see *Introduction To Fundamental Analysis* and *What Are Fundamentals?*)

What follows is a brief discussion of 12 common financial statement characteristics to keep in mind before you start your analytical journey.

2. What Financial Statements to Use

For investment analysis purposes, the financial statements that are used are the balance sheet, the income statement and the cash flow statement. The statements of shareholders' equity and retained earnings, which are seldom presented, contain nice-to-know, but not critical, information, and are not used by financial analysts. A word of caution: there are those in the general investing public who tend to focus on just the income statement and the balance sheet, thereby relegating cash flow considerations to somewhat of a secondary status. That's a mistake; for now, simply make a permanent mental note that the cash flow statement contains critically important analytical data. (To learn more, check out *Reading The Balance Sheet*, *Understanding The Income Statement* and *The Essentials Of Cash Flow*.)

3. Knowing What's Behind the Numbers

The numbers in a company's financials reflect real world events. These numbers and the financial ratios/indicators that are derived from them for investment analysis are easier to understand if you can visualize the underlying realities of this essentially quantitative information. For example, before you start crunching numbers, have an understanding of what the company does, its products and/or services, and the industry in which it operates.

4. The Diversity of Financial Reporting

Don't expect financial statements to fit into a single mold. Many articles and books on financial statement analysis take a one-size-fits-all approach. The less-experienced investor is going to get lost when he or she encounters a presentation of accounts that falls outside the mainstream or so-called "typical" company. Simply remember that the diverse nature of business activities results in a diversity of financial statement presentations. This is particularly true of the balance sheet; the income and cash flow statements are less susceptible to this phenomenon.

5. The Challenge of Understanding Financial Jargon

The lack of any appreciable standardization of financial reporting terminology complicates the understanding of many financial statement account entries. This circumstance can be confusing for the beginning investor. There's little hope that things will change on this issue in the foreseeable future, but a good financial dictionary can help considerably.

6. Accounting Is an Art, Not a Science

The presentation of a company's financial position, as portrayed in its financial statements, is influenced by management estimates and judgments. In the best of circumstances, management is scrupulously honest and candid, while the outside auditors are demanding, strict and uncompromising. Whatever the case, the imprecision that can be inherently found in the accounting process means that the prudent investor should take an inquiring and skeptical approach toward financial statement analysis. (For related content, see *Don't Forget To Read The Prospectus!* and *How To Read Footnotes - Part 2: Evaluating Accounting Risk*.)

7. Two Key Accounting Conventions

Generally accepted accounting principles (GAAP) are used to prepare financial statements. The sum total of these accounting concepts and assumptions is huge. For investors, a basic understanding of at least two of these conventions - historical cost and accrual accounting - is particularly important. According to GAAP, assets are valued at their purchase price (historical cost), which may be significantly different than their current market value. Revenues are recorded when goods or services are delivered and expenses recorded when incurred. Generally, this flow does not coincide with the actual receipt and disbursement of cash, which is why the cash flow becomes so important.

8. Non-Financial Statement Information

Information on the state of the economy, industry and competitive considerations, market forces, technological change, and the quality of management and the workforce are not directly reflected in a company's financial statements. Investors need to recognize that financial statement insights are but one piece, albeit an important one, of the larger investment information puzzle.

9. Financial Ratios and Indicators

The absolute numbers in financial statements are of little value for investment analysis, which must transform these numbers into meaningful relationships to judge a company's financial performance and condition. The resulting ratios and indicators must be viewed over extended periods to reflect trends. Here again, beware of the one-size-fits-all syndrome. Evaluative financial metrics can differ significantly by industry, company size and stage of development.

10. Notes to the Financial Statements

It is difficult for financial statement numbers to provide the disclosure required by regulatory authorities. Professional analysts universally agree that a thorough understanding of the notes to financial statements is essential in order to properly evaluate a company's financial condition and performance. As noted by auditors on financial statements "the accompanying notes are an integral part of these financial statements." Take these noted comments seriously. (For more insight, see *Footnotes: Start Reading The Fine Print*.)

11. The Auditor's Report

Prudent investors should only consider investing in companies with audited financial statements, which are a requirement for all publicly traded companies. Before digging into a company's financials, the first thing to do is read the auditor's report. A "clean opinion" provides you with a green light to proceed. Qualifying remarks may be benign or serious; in the case of the latter, you may not want to proceed.

12. Consolidated Financial Statements

Generally, the word "consolidated" appears in the title of a financial statement, as in a consolidated balance sheet. Consolidation of a parent company and its majority-owned (more that 50% ownership or "effective control") subsidiaries means that the combined activities of separate legal entities are expressed as one economic unit. The presumption is that a consolidation as one entity is more meaningful than separate statements for different entities.

Conclusion

The financial statement perspectives provided in this overview are meant to give readers the big picture. With these considerations in mind, beginning investors should be better prepared to cope with learning the analytical details of discerning the investment qualities reflected in a company's financials.

Trade Like a Top Hedge Fund

What can technical traders see that you don't? Investopedia presents Five Chart Patterns You Need to Know, your guide to technical trading like the pros. Click here to get started, and learn how to read charts like an industry veteran.

5 Services To Usher In New Clients


Sneaky Subsidiary Tricks Can Cloud Financials


Analyzing A Bank's Financial Statements